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IN THE

Supreme Court of the United States

OCTOBER TERM 1949

No. [redacted] 94

TRUST COMPANY OF GEORGIA,
Petitioner,

vs.

MARION H. ALLEN, *Collector of Internal Revenue,*
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT.

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Trust Company of Georgia prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit entered March 2, 1950, reversing the Judgment of the District Court of the United States for the Middle District of Georgia.

OPINION BELOW

The findings of fact and conclusions of law of the District Court (R. 34) were not reported. The opinion of the Court of Appeals is reported in 180 F. (2d) 527 (R. 44-47).

JURISDICTION

The judgment of the Court of Appeals was entered March 2, 1950. The jurisdiction of this Court is invoked under Title 28 United States Code, Sec. 1254 and Sec. 2101.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the statutes and regulations are set out in the Appendix, page 10.

SUMMARY STATEMENT

Petitioner sought to underwrite the sale of certain stock which represented 60% control of a corporation. In order to obtain this right, and to provide interim financing pending the sale, petitioner made a loan of $400,000 secured by the stock. The borrower became totally insolvent. The management of the corporation deteriorated and its stock depreciated until it was worth only a fraction of the loan. To prevent a complete loss, petitioner took over the stock in satisfaction of the debt and thereafter looked solely to the collateral for recovery. By various means, including change of management, formation of a creditors' committee, advances to the corporation, sale of part of the stock to key employees as incentive, and contribution of part of the stock to the corporation, petitioner was able to rehabilitate the corporation and restore the value of the stock. It finally sold the stock for an amount sufficient to recover the full amount of the loan. (R. 35-37)

Petitioner had a net loss in the year in which it took over the stock and therefore received no tax benefit from the interim loss on taking over the stock. (R. 38)

The trial court found as a fact that to the extent that the sales price of the stock represented recovery of the interim loss in taking over the stock, for which petitioner received no tax benefit, petitioner realized no gain on the sale. (R. 38)

The trial court further found as a fact that the understanding regarding the underwriting agreement, the making of the loan, the taking over of the stock, the rehabilitation of the company, and the final sale of the stock was one integrated transaction, bringing the transaction within the rule laid down by this Court in *Dobson* v. *Commissioner*, 320 U. S. 489. (R. 38)

The Court of Appeals for the Fifth Circuit reversed, holding:

> "The pledged shares of stock had no more relation to the debt than the shares of some totally unrelated corporation would have had." (R. 46).

and

> "The making of the loan in 1931, the acceptance of the stock in 1932 in cancellation of the debt, and the subsequent sale of the stock at a gain in 1940 were not part of one integrated transaction. The finding to the contrary seems to us clearly erroneous." (R. 46).

This Court in the *Dobson* case (320 U. S. 489) specifically held that the principle, exemplified by Sec. 22(b)(12) of the Code, that the recovery of an interim loss from which no tax benefit was obtained is to be excluded from gross income, was not limited to the transactions set out in the statute but applied equally to all other such losses. In obedience to that decision, the regulations were amended, by T. D. 5454 (1945 C. B. 68) so as to state that the principle set out in Sec. 22(b)(12) "applies equally with respect to all other losses, expenditures and accruals made the basis of deductions from gross income for prior taxable years" with certain exceptions not here material (App. p. 11).

The Court of Appeals said of that amended regulation:

> "As for that part of Treasury Regulation 103 which with certain exceptions extends the rule of exclusion as prescribed by statute 'to all other losses' we do not construe to be broader than the statutes on the subject. To construe it broader than warranted by statutory authority would render it void as to the unauthorized portion." (R. 46).

When the debtor became insolvent, and petitioner who made the loan was forced to take over the stock which was held as collateral in settlement of the debt, the real result was as follows:

Petitioner, the creditor, no longer looked to the person of

the debtor for collection, but looked solely to its collateral. The release of the debtor from personal liability merely limited to the collateral the source from which recovery might be obtained. This recovery could not be effected until this limited source achieved a value equal to the amount of the loss. In order, therefore, to restore the value of the collateral, petitioner had to rehabilitate the company whose stock it held. This required it, among other things, to reorganize the management of the company, place some of its stock in the hands of the company's managers to induce an interest in the development of the company, and advance money to the company. All of this required great managerial skill and ability exercised over a period of time and all of it was done for the purpose of rehabilitating the value of its collateral and in turn collecting the loss which resulted from the debt.

QUESTIONS PRESENTED

(1) Where the trial court has found a transaction to be an integrated transaction within the meaning of the *Dobson* case and the regulation giving effect to that case, upon undisputed facts showing that a creditor who accepted collateral from an insolvent debtor of substantially less value than the amount of the debt and released the debtor from personal liability and thereafter for the purpose of recouping its loss, through managerial skill and ability exercised over a period of years, rehabilitated the business represented by the collateral, thus restoring the value of the collateral, from the sale of which the amount loaned was finally recovered, is the Circuit Court of Appeals empowered as a matter of law to reverse that finding of fact and hold that the transaction is not an integrated transaction within the meaning of the law governing the imposition of taxes?

(2) Does the action of the Circuit Court of Appeals, in so holding, narrow and restrict the meaning of the *Dobson* case and nullify the regulation made in compliance therewith?

(3) Did the Court of Appeals misconceive the nature of the transaction, the result of which was improperly to reverse the trial court on a question of fact which in turn resulted in

narrowing the legal effect of the *Dobson* case and nullifying the regulation which was promulgated to give effect to that case?

REASONS FOR GRANTING WRIT

1. The question presented is one of great public interest. It involves a problem of proper administration of the tax law. The decision throws much confusion on the question of what constitutes an integrated transaction and casts doubt on the meaning, or validity, of the Treasury regulation. While not directly declaring the regulation invalid, the court said that it must be limited to the transactions set out in the statute, which entirely emasculates its meaning, or else must be held invalid.

As this Court said in the *Dobson* case, it ought never to have been necessary for Congress to have enacted Section 22(b)(12). It was occasioned by the error of the courts, such as of the Court of Appeals in this case, in misconceiving the basic principle of taxation and, by the application of technical rules, finding taxable income where no economic gain in fact exists. The statute was intended to relieve against this erroneous technical construction of the law. The principle that the recovery of interim losses for which no tax benefit was received is not taxable income, of which that statute was but one application, is much broader than the statute and applies to transactions which are not within the literal language of the statute. The transaction involved in the *Dobson* case itself confessedly was not within the language of the statute. Following the *Dobson* case, the regulation was amended to make it clear that the principle was not dependent upon the statute nor narrowly limited to the transactions therein set out, but applied to all like losses. The Court of Appeals now holds that the amended regulation must be limited to the language of the statute or else held void.

The question has unusual public interest for the reason that the underlying reasoning of the Court of Appeals fails to recognize the true nature of the basis upon which taxes are enacted and fails to recognize the underlying meaning of the *Dobson* case.

The error of the Court of Appeals consisted in the holding that because the creditor, in maneuvering to save itself from further loss, took over the collateral and took charge of the corporation controlled by the collateral, releasing the insolvent debtor from personal liability, it thereby ended one transaction and began a new and unrelated transaction. The taking over of the collateral did not in any sense repay the loan, nor did the creditor thereby give up anything of value, since the personal liability of the debtor was worthless. All the creditor had to look to was the collateral, which was then worth much less than the debt. It took over collateral only in order to secure more freedom in the management of the collateral (and of the corporation) to which alone it had to look for repayment.

Petitioner, a banking institution, was prohibited by law from retaining the collateral as a permanent investment. The law only permitted it to take over and hold the collateral for the purpose of preventing further loss, or of recovering its loss, by the ultimate sale of the collateral. Therefore, the taking over and holding of the collateral was legal only because integrated with the loan and the ultimate sale.

Taxation is an intensely practical matter and is levied upon real income. A taxpayer does not realize any increase in wealth through merely recovering the amount loaned, whether such recovery is from the personal liability of the debtor or from the collateral pledged to secure the debt.

The ruling of the Court of Appeals restricting the fact-finding function of the trial court is of great importance in the administration of the tax law, for the ruling of the Court of Appeals will apply equally to the findings of fact of the Tax Court.

> "The Court of Appeals shall have exclusive jurisdiction to review the decisions of the Tax Court * * * in the same manner and to the same extent as decisions of the District Courts in civil actions tried without a jury."
>
> I. R. C. Sec. 1141(a).

2. The holding of the Court of Appeals that, as a matter of law, the trial court cannot find one integrated transaction under the circumstances of this case is clearly contrary to the decisions of this Court in *Dobson* v. *Commissioner*, 320 U. S. 489, *Bowers* v. *Kerbaugh-Empire Co.*, 271 U. S. 170, and *Allen* v. *Trust Company of Georgia*, 326 U. S. 630. It is also clearly contrary to the decisions of other federal courts in *Boehm* v. *Commissioner*, (CCA-2) 146 F. (2d) 553, aff'd 326 U. S. 287, *Maurice A. Mittelman*, 7 T. C. 1162 (Acq. 1947-1 C. B. 3), and *Main Properties, Inc.*, 4 T. C. 364 (Acq. 1945 C. B. 5).

In *Dobson* v. *Commissioner* taxpayers purchased certain stock in 1929. In 1930 they sold the stock at a loss. The loss was claimed and allowed on their returns for that year, but because of other losses taxpayers secured no tax benefit from the loss. In 1936 they discovered they had been defrauded in the purchase of the stock. They brought suit against the seller. In 1939 the suit was settled by a cash payment. The Commissioner contended that the sales in 1930 were closed and completed transactions and that the recovery in 1939 was therefore taxable income. The Board of Tax Appeals held, however, that considering the transaction as a whole it was obvious that the taxpayers realized no economic gain, and therefore had no taxable income, to the extent that the taxpayers received no tax benefit from the loss in 1930.

Dobson case, in trial court, sub nom.
Estate of James N. Collins,
46 B. T. A. 765

The Court of Appeals held that, as a matter of law, the Board could not find that the transaction was one integrated transaction, and that the several transactions must be viewed as separate and distinct.

Dobson case, in Circuit Court, sub nom.
Harwick v. *Commissioner*,
(CCA-8) 133 F. (2d) 732.

This Court reversed, holding that the trial court was authorized to find that the series of transactions was one integrated

transaction and that there was no economic gain and therefore no taxable income to the extent that the taxpayers merely recovered their original investment and received no tax benefit from the interim loss. The pertinent extracts from the opinion of this Court are set out in the Appendix, page 12.

In *Bowers* v. *Kerbaugh-Empire Co.*, 271 U. S. 170, the taxpayer borrowed money payable in German marks or their equivalent. The money was borrowed for use of subsidiaries and was lost, but taxpayer received no tax benefit from the loss. It subsequently paid the debt with depreciated marks. The Commissioner contended that taxpayer realized taxable income on such payment. This Court held that since the result of the whole transaction was a loss, and no tax benefit was obtained from the interim loss, no taxable income was realized.

> "The essential facts set forth in the complaint are the loans in 1911, 1912 and 1913, the loss in 1913 to 1918 of the monies borrowed, the excess of such losses over income by more than the item here in controversy, and payment in the equivalent of marks greatly depreciated in value. The result of the whole transaction was a loss." (P. 175.)

In *Allen* v. *Trust Company of Georgia*, 326 U. S. 630, this Court said.

> "The findings make plain that the establishment of the trust in 1925, their enlargement in 1934, and the release of the power to amend in 1937 were part of one integrated transaction. That is a finding of fact which we are not at liberty to disturb on this record." (P. 637.)

3. The holding of the Court of Appeals that the amended regulation must be construed as limited to the transactions set out in Section 22(b)(12), or else void, is directly contrary to the decision of this Court in *Dobson v. Commissioner*, 320 U. S. 489.

In the *Dobson* case, it was conceded that the transaction did not fall within Section 22(b)(12). The Commissioner argued that Congress, by adopting Section 22(b)(12), evidenced an

intent that the principle not be applied to transactions not within the statute. This Court said (p. 506):

> "The government now argues that by extending legislative relief in bad debt cases Congress recognized that in the absence of specific exemptions recoveries are taxable as income. We do not find that significance in the amendment. A specific statutory exception was necessary in bad debt cases only because the courts reversed the Tax Court and established as a matter of law a 'theoretically proper' rule which distorted the taxpayer's income. Congress would hardly expect the courts to repeat the same error in another class of cases as we would do were we to affirm this case."

In compliance with that decision, the regulations were amended by T. D. 5454 (1945 C. B. 68) by adding the following language:

> "The rule of exclusion so prescribed by statute applies equally with respect to all other losses, expenditures and accruals made the basis of deductions from gross income for prior taxable years including war losses referred to in section 127, but not including deductions with respect to depreciation, depletion, amortization or amortizable bond premium. See Dobson v. Commissioner, 64 S. Ct. 239."

The Court of Appeals now rules that the above language must be construed as limited to the statute, or else is unauthorized and void.

Respectfully submitted,

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APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

* * * * * *

(b) *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

* * * * * *

(12) [as added by Sec. of the Revenue Act of 1942, c. 619, 56 Stat. 789] [1]*Recovery of bad debts, prior taxes, and delinquency amounts.*—Income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount. For the purposes of this paragraph:

(A) *Definition of Bad Debt.*—The term "bad debt" means a debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

* * * * * *

(D) *Definition of Recovery Exclusion.*—The term "recovery exclusion," with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this chapter (not including the tax under section 102) or corresponding provisions of prior revenue laws, reduced by the

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[1]Subsection (b) of Section 116 made these additions applicable with respect to taxable years beginning after December 31, 1938, and subsection (c) made them effective as if a part of the Revenue Act of 1938 and prior Revenue Acts.

amount excludible in previous taxable years with respect to such debt, tax or amount under this paragraph.

* * * * * *

(26 U. S. C. 1946 ed., Sec. 22.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

Sec. 19.22(b)(12)-1 [as added by T. D. 5288, 1943 Cum. Bull. 103, and amended by T. D. 5454, 1945 Cum. Bull. 68]. *Recovery of Certain Items Previously Deducted.*—(a) *In General.*—Section 22(b)(12) provides that income attributable to the recovery during any taxable year of bad debts, prior taxes, and delinquency amounts shall be excluded from gross income to the extent of the "recovery exclusion" with respect to such items. The rule of exclusion so prescribed by statute applies equally with respect to all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years, including war losses referred to in section 127, but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums. (See *Dobson* v. *Commissioner*, 64 S. Ct. 239.) The term "recovery exclusion" as used in these regulations means accordingly an amount equal to the portion of the bad debts, prior taxes, and delinquency amounts (the items specifically referred to in section 22(b)(12)), and of all other items subject to the rule of exclusion which, when deducted or credited for a prior taxable year, did not result in a reduction of any tax of the taxpayer under Chapter 1 of the Internal Revenue Code (other than a tax under section 102) or under corresponding provisions of prior revenue laws.

(1) *Section 22(b)(12) items.*—The term "section 22(b)(12) items" as used in these regulations means those bad debts, prior taxes, delinquency amounts, and all other items subject to the rule of exclusion, for which a deduction or credit was allowed for a prior taxable year. If a bad debt was previously charged against a reserve by a

taxpayer on the reserve method of treating bad debts, it was not deducted, and it is therefore not considered a section 22 (b) (12) item. Bad debts, prior taxes, and delinquency amounts are defined in section 22(b) (12) (A), (B), and (C), respectively. A typical example of a delinquency amount described in that section is interest upon delinquent taxes. A typical example of the other items not expressly referred to in section 22(b) (12) but nevertheless subject to the rule of exclusion is a loss sustained upon the sale of stock and later recovered, in whole or in part, through an action against the party from whom such stock had been purchased.

(2) *Definition of "recovery."*—Recoveries result from the receipt of amounts in respect of the previously deducted or credited items described in section 22(b) (12), such as from the collection or sale of a bad debt, refund or credit to taxes paid, or cancellation of taxes accrued. Care should be taken in the case of bad debts which were treated as only partially worthless in prior years to distinguish between the item described in section 22(b) (12), that is, the part of such debt which was deducted, and the part not previously deducted, which is not a section 22(b) (12) item and is considered the first part collected. The collection of the part not deducted is not considered a "recovery." * * *

QUOTATIONS

Dobson v. *Commissioner*
320 U. S. 489

"He [the taxpayer] contended that the recovery of 1939 was in the nature of a return of capital from which he realized no gain and no income either actually or constructively, and that he had received no tax benefit from the loss deductions. . . . (p. 492).

"The Court of Appeals concluded that the 'tax benefit theory' applied by the Tax Court 'seems to be an injection into the law of an equitable principle, found neither in

the statutes nor in the regulations.' Because the Tax Court's reasoning was not embodied in any statutory precept, the court held that the Tax Court was not authorized to resort to it in determining whether the recovery should be treated as income or return of capital. It held as matter of law that the recoveries were neither return of capital nor capital gain, but were ordinary income in the year received . . . (p. 492).

"The court below thought that the Tax Court's decision 'evaded or ignored' the statute of limitation, the provision of the Regulations that 'expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year,' and the principle that recognition of a capital loss presupposes some event of 'realization' which closes the transaction for good. We do not agree. The Tax Court has not attempted to revise liability for earlier years closed by the statute of limitation, nor used any expense, liability, or deficit of a prior year to reduce the income of a subsequent year. It went to prior years only to determine the nature of the recovery, whether return of capital or income. Nor has the Tax Court reopened any closed transaction; it was compelled to determine the very question whether such a recognition of loss had in fact taken place in the prior year as would necessitate calling the recovery in the taxable year income rather than return of capital. . . . (p. 493).

"The Government says that 'the principal question in this case turns on the application of the settled principle that the single year is the unit of taxation.' But the Tax Court was aware of this principle and in no way denied it. Whether an apparently integrated transaction shall be broken up into several separate steps and whether what apparently are several steps shall be synthesized into one whole transaction is frequently a necessary determination in deciding tax consequences. Where no statute or regulation controls, the Tax Court's selection of the course to follow is no more reviewable than any other question of fact. Of course we are not here considering the scope of

review where constitutional questions are involved. The Tax Court analyzed the basis of the litigation which produced the recovery in this case and the obvious fact that 'regarding the series of transactions as a whole it is apparent that no gain was actually realized.' It found that the taxpayer had realized no tax benefits from reporting the transaction in separate years. It said the question under these circumstances was whether the amount the taxpayer recovered in 1939 'constitutes taxable income, even though he realized no economic gain.' It concluded that the item should be treated as a return of capital rather than as taxable income. . . . (p. 502-3).

"Viewing the problem from a different aspect, the Government urges in this Court that although the recovery is capital return, it is taxable in its entirety because taxpayer's basis for the property in question is zero. The argument relies upon Sec. 113(b)(1)(A) of the Internal Revenue Code, which provides for adjusting the basis of property for 'expenditures, receipts, losses, or other items, properly chargeable to capital account.' This provision, it is said, requires that the right to a deduction for a capital loss be treated as a return of capital. Consequently, by deducting in 1930 and 1931 the entire difference between the cost of his stock and the proceeds of the sales, taxpayer reduced his basis to zero. But the statute contains no such fixed rule as the Government would have us read into it. It does not specify the circumstances or manner in which adjustments of the basis are to be made, but merely provides that 'Proper adjustment . . . shall in all cases be made' for the items named if 'properly chargeable to capital account.' What, in the circumstances of this case, was a proper adjustment of the basis was thus purely an accounting problem and therefore a question of fact for the Tax Court to determine. Evidently the Tax Court thought that the previous deductions were not altogether 'properly chargeable to capital account' and that to treat them as an entire recoupment of the value of taxpayer's stock would not have been a 'proper

adjustment.' We think there was substantial evidence to support such a conclusion. . . . (503-4).

"It is argued on behalf of the Commissioner that the Court should overrule the Board by applying to this question rules of law laid down in decisions on the analogous problem raised by recovery of bad debts charged off without tax benefit in prior years. The court below accepted the argument. However, instead of affording a reason for overruling the Tax Court, the history of the bad debt recovery question illustrates the mischief of overruling the Tax Court in matters of tax accounting. Courts were persuaded to rule as matter of law that bad debt recoveries constitute taxable income, regardless of tax benefit from the charge-off. The Tax Court had first made a similar holding, but had come to hold to the contrary. Substitution of the courts' rule for that of the Tax Court led to such hardships and inequities that the Treasury appealed to Congress to extend relief. It did so. The Government now argues that by extending legislative relief in bad debt cases Congress recognized that in the absence of specific exemption recoveries are taxable as income. We do not find that significance in the amendment. A specific statutory exception was necessary in bad debt cases only because the courts reversed the Tax Court and established as matter of law a 'theoretically proper' rule which distorted the taxpayer's income. Congress would hardly expect the courts to repeat the same error in another class of cases, as we would do were we to affirm in this case.

". . . We only hold that no statute or regulation having the force of one and no principle of law compels the Tax Court to find taxable income in a transaction where as matter of fact it found no economic gain and no use of the transaction to gain tax benefit. The error of the court below consisted of treating as a rule of law what we think is only a question of proper tax accounting." (p. 506-7).